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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Current Economic Trends in Western Europe

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ER IM 73-10
January 1973

Copy No. 89

Approved For Release 2006/04/19 : CIA-RDP85T00875R001700050008-7

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INTELLIGENCE MEMORANDUM

CURRENT ECONOMIC TRENDS IN WESTERN EUROPE

1. Business is picking up in Western Europe. The cyclical slowdown, aggravated by the 1971 international monetary crisis, had generally bottomed out by mid-1972. Although the strength of recovery varies, virtually all countries report improvement in their economic performance. The real growth of gross national product (GNP) averaged about 4% in 1972, up from 3% in 1971. With most systems "go," government, business, and labor leaders expect a further upsurge in economic activity this year. Expected real growth rates range from 4% in Italy to 6% in France and West Germany (see the table). The average for Western Europe should easily top 5%, compared with 6-1/2% in the United States and 10% in Japan.

2. A high level of consumer buying and rising government spending last year, especially in the United Kingdom and West Germany, cushioned the slowdown precipitated by flagging investment demand that reflected businessmen's worries about shrinking profit margins and declining export growth. Widespread fears of an impending recession thus proved groundless. Also, the return to fixed exchange rates, following the December 1971 Smithsonian agreement, provided a further boost to business confidence. Export demand, generally sluggish during the first half of 1972, revived strongly in the latter part of the year, led by sharply rising orders for consumer goods and industrial raw materials. Last year the gradual rise in industrial output reflected primarily a fuller utilization of productive capacity. Increasing profit margins and the generally improved business outlook are now generating a new spurt in investment that will accelerate in the course of the year.

3. Inflation is a serious problem throughout Western Europe, and unemployment is unacceptably high in a number of countries, including France, Italy, and the United Kingdom. The economic slowdown generally

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

Gross National Product in Selected West European Countries

Country	GNP in 1972 (Billion Current US $)[a]	Real Growth over Preceding Year (Percent) 1972	1973[b]
Austria	20.1	5.5	5½
Belgium	34.6	4.0	4½-5
Denmark	20.7	4.5	5½
Finland	12.9	4.5	6
France	198.0	5.5	6
Ireland	5.2[c]	3.0	4
Italy	118.0	3.0	4
Netherlands	45.1	3.5	4½
Norway	16.5	4.2	4-5
Sweden	41.4	2.0	4
Switzerland	29.8	4.5	4-4½
United Kingdom	133.0[c]	3.5	5
West Germany	257.0	3.3	6

a. Unless otherwise indicated, converted to dollars at Smithsonian exchange rates.
b. Forecast.
c. Converted at the rate of $2.50 to the pound.

was too short and too mild to check inflationary tendencies, and the renewed upswing is too recent to have generated a substantial rise in employment. Despite government efforts to control inflation, living cost increases have accelerated in virtually all countries. Led by sharply rising prices for foodstuffs and services, especially rents, the increase in consumer prices reached an annual rate of about 7% by the end of 1972. The seriousness of the problem is underscored by the fact that many West European countries, most importantly West Germany, are entering the expansionary phase of their business cycle with rates of inflation exceeding those prevailing during the preceding peak. Moreover, in those countries also plagued by large-scale unemployment, the high rate of inflation inhibits government efforts to create more jobs.

4. Governments throughout Western Europe recognize that fighting inflation requires careful management of aggregate demand, including a curb on public expenditures, a slowdown in the growth of the money supply, and tighter credit policies. In addition, it requires extensive labor-management cooperation to hold down excessive wage and price

increases. Central government budgets for 1973 – other than in Italy and the United Kingdom – generally project expenditure increases roughly in line with, or less than, the expected growth of money GNP. But with much of the recent increase in public spending coming from state and local bodies beyond the immediate control of the central authorities, the overall impact of government spending remains uncertain. With the exception of the United Kingdom, currently introducing Phase II of its stabilization program, and, on a more limited scale, Ireland, none of the West European countries has adopted systematic wage-price guidelines, much less a formal incomes policy comprehensively defining permissible wage and price increases. A number of countries, however, including France, the Netherlands, and Norway, maintain limited controls over prices.

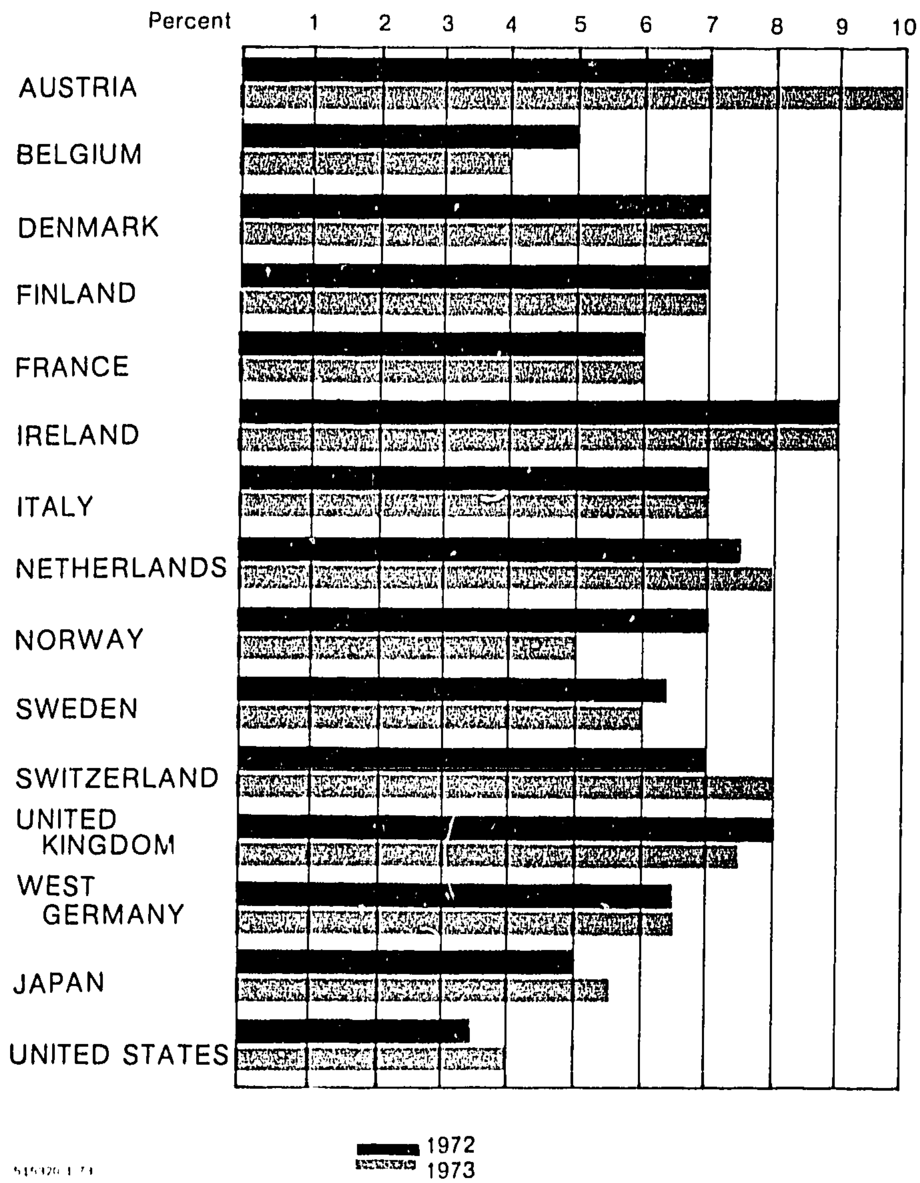
5. With economic expansion accelerating, price pressures are not likely to ease significantly in the absence of more stringent controls (see the chart). Labor probably will intensify its wage demands as living costs continue to rise and jobs become more plentiful. There are already signs of increasing union militancy in some of the West European countries – France, the United Kingdom, and West Germany – that could precipitate disruptive strikes if wage demands are not met.

6. The broadly based 1973 economic upsurge in Western Europe should sharply boost US exports and improve the global US trade balance. Last year the traditionally large US trade surplus with Western Europe turned into a sizable deficit. For cyclical reasons, the United States purchased more goods from Western Europe than it was able to sell there. The Smithsonian currency realignment, moreover, raised the dollar costs of US imports without immediately affecting the volume of trade in either direction. US economic growth in 1973 is expected again to exceed that of Western Europe, but the growth differential is narrowing. Moreover, with capacity utilization already relatively high, the West European countries increasingly will have to expand their productive plant to raise output. Rapidly rising wages in all of the countries and labor shortages in some will also stimulate heavier investment in labor-saving machinery. Both factors promise a broadening market for high-technology US machinery and equipment. At the same time, inflationary pressures in Western Europe will remain stronger than in the United States, increasing the competitive edge gained by US manufacturers from the Smithsonian currency realignment.

Austria

7. Austria's longest and strongest postwar economic boom shows no signs of weakening. Strong consumer spending generated by virtually full employment and rapidly rising wages, buoyant investment in machinery and equipment, flourishing exports, and thriving tourist business all combined

Consumer Price Increases in Selected Industrialized Countries, 1972 and 1973



to generate a 5-1/2% growth in real GNP. Inflation is the only major problem casting a shadow on this otherwise rosy picture. The rise in living costs accelerated, with the consumer price index up nearly 7% for the year.

8. Growth is expected to continue unabated in 1973, with real GNP rising another 5-1/2%. The recent reciprocal 30% reduction in tariffs on industrial trade between Austria and the European Community (EC) countries and the cyclical upswing in West Germany, Austria's principal trading partner, should give a further boost to export trade, stimulate continued rapid growth of investment, and guarantee full employment. Inflation will remain the major issue. The high level of capacity utilization in industry, the tight labor market, and the recent introduction of a value-added tax could accelerate cost of living increases to as much as 10%. To head off excessive price increases the government and the National Bank instituted a six-months' "cooling off" period, and labor and management agreed on a "stabilization pact." The effectiveness of these measures remains to be seen.

Belgium

9. The Belgian economy last year staged a mild comeback from its short-lived 1971 slowdown. Real economic growth exceeded 4%. Private consumption and government spending were the main expansionary force throughout the year. Investment rose only marginally, reflecting in part more cautious foreign investment in Belgian construction and manufacturing industries. Industrial production, stagnant during most of 1971, picked up rapidly in 1972, paced by the output of consumer goods and export-oriented industries. Despite the overall improvement in industrial activity, unemployment continued to rise through most of 1972, averaging about 2% of the labor force for the year. Nevertheless, wages and salaries have continued to rise sharply, contributing to rising inflationary pressures. The cost of living in 1972 rose about 5%, high by past Belgian standards but somewhat below the West European average.

10. Economic expansion is expected to accelerate in 1973, with real growth reaching 4-1/2% to 5%. In the face of favorable world trade and domestic sales prospects, manufacturing industries are planning a significant rise in investment. Housing starts also are expected to be up substantially. Private consumption and government spending should grow at approximately last year's rate. Export demand will remain strong, but the trade surplus will decline as faster domestic growth generates a more rapid rise in imports. Unemployment is not likely to decline significantly during the year, because employers tend to increase working hours as the expansion gathers momentum rather than hire additional workers. Continuing slack in the labor market combined with increases in labor productivity should moderate inflationary pressures.

Denmark

11. Recovering from a slump, the Danish economy registered real growth of 4.5% in 1972, up from 3.6% in 1971. The removal of the EC's import duties on cattle and large sales of butter to the United Kingdom, which helped raise Danish exports 20% over 1971, were a major factor aiding the recovery. Consumer demand, lethargic in 1971, grew 3.5% during the year. Adversely affected by uncertainty concerning the ratification of EC membership, industrial investment lagged, posting a gain of less than 3% over 1971. Reacting to increased export demand, industrial production grew about 5% in 1972, reducing unemployment to only 1% by the end of the year. Inflationary wage increases, brought on by the high level of employment, contributed to a 7% rise in consumer prices in 1972.

12. Prospects for 1973 are for real growth in GNP of about 5-1/2%. Denmark's entry into the EC is expected to produce a major increase in investment expenditures. Continuing recovery of consumer demand should also help fuel the expansion. Industrial production is expected to increase by nearly 6% as export demand remains high and inventories are built up. The principal problem area is inflation, which is expected to continue at about the same rate as in 1972.

Finland

13. The Finnish economy in 1972 pulled out of an 18-month recession. The GNP posted a real gain of 4.5% over 1971. Stimulated by a 25% increase in demand for exports – mainly paper, lumber, and metals – industrial production for the first eight months of 1972 was 9% higher than the corresponding period a year earlier. This figure overstates the recovery, however, as strikes had cut heavily into 1971 production. Consumption showed a modest increase in 1972. Despite a gradual easing of the money markets caused mainly by government policy actions, businessmen were reluctant to invest because of the uncertainties surrounding the signing of an industrial free trade agreement with the EC. Inflation remained a major problem in 1972, as consumer prices rose nearly 7% compared with 6% a year earlier. Despite the pick-up in the economy, unemployment rose to 2.7% of the labor force, up from 2.2% in 1971.

14. The economic revival is expected to gather steam in 1973 as the signing of an EC agreement stimulates industrial investment and exports. Real GNP may rise by as much as 6%. This expansion should reduce the unemployment rate to the 1971 level. But inflationary pressures probably will continue virtually unabated, causing another 7% rise in the cost of living.

France

15. The French economy was strong throughout 1972, with real GNP growing by 5.5%. Consumer demand and private investment were buoyant, and governmental policy shifted from being moderately expansionary to a more neutral stance. Businessmen became increasingly optimistic after the first quarter as orders steadily mounted and inventories declined. The balance of payments, as well as the trade balance, remained in surplus, as French exporters continued to exploit the price advantage obtained from the currency realignments of recent years. The main problem is inflation. Prices, up 6% for the year, have been rising at a 9% annual rate in recent months. Unemployment leveled off by September but remains high by French standards at about 2.5%.

16. The outlook is basically for more of the same in 1973. Investment should rise by nearly 7.5%, leading to growth of close to 6% in real GNP. Some improvement may occur with respect to unemployment and the balance of payments. But inflation, fueled by 11% wage increases, is likely to worsen unless the growing public discontent forces the government to take stronger action. The big question mark is the March legislative election. Recent polls suggest the likelihood of large gains for the leftist coalition. Although a leftist victory appears unlikely, the prospect of a significant loss of power by the Gaullists could disrupt investment plans and lead to increased hoarding and a considerable flight of capital.

Ireland

17. With its real GNP growing at about 3% a year, Ireland in 1972 continued to recover slowly from the 1969-70 economic slump. Growth was led by expanding exports and consumer spending, and investment showed some improvement. With imports sluggish – reflecting the economy's slow pace – and exports rising rapidly, the trade balance improved in 1972. Unemployment, ranging from 7% to 8%, and inflation, fed by rapidly rising wages, remain major problems. In 1972, consumer prices probably went up about 9%, the sharpest rise in Western Europe. Official efforts to slow inflation were restrained by fear of aggravating unemployment.

18. In prospect for 1973 are a gradual pick-up in growth (possibly to 4% or so), continued rapid inflation, and continued high unemployment. The widened duty-free market resulting from Ireland's entry into the EC and the lagged effects of floating the Irish pound should stimulate export industry and enhance Ireland's attractiveness for foreign investment. The favorable impact on employment, however, is not likely to be strong in the short run. With unemployment remaining high, the government will

hesitate to curtail the growth of the money supply. With the labor unions militantly opposed to controls, wages will continue to rise. Led by soaring food prices, inflation is likely to continue at about 9%.

Italy

19. In 1972 – and extending into 1973 – political and economic uncertainties in Italy have loomed large in slowing economic recovery. The growth of real GNP in 1972 was 3%, disappointing but still an improvement over the 1.4% posted in 1971. Although total governmental spending was up, public investment fell considerably short of the mark, partly because of the usual bureaucratic red tape. Private business investment was adversely affected throughout the year by fears that the fall labor negotiations could result in serious disruption of production and certainly would bring higher labor costs. Consumer spending was held down by the relatively high level of unemployment. The sluggish economy moderated import demand while brisk recovery in major foreign markets spurred Italy's exports, generating a sizable trade surplus in 1972. Undeterred by growing unemployment, labor intensified its wage demands, contributing to the sharp increase in prices. By the end of the year, living costs were rising at an annual rate of nearly 8%.

20. Gradual recovery will continue in 1973, with real GNP growing about 4%. If settlement of the remaining major labor contracts (for example, the metal workers' contract) comes early in the year, it should remove considerable uncertainty from the business outlook and help stimulate an upturn in private investment despite higher production costs. Consumer expenditures should expand as workers become more secure in their jobs and spend a larger portion of their wages. Public sector spending will continue to be somewhat expansionary. The biggest problems in 1973 will be inflation and pressure on the lira. Aggravated by wage increases and introduction of the value-added tax system, consumer prices are expected to rise at least as much as in 1972. Largely reflecting the uncertainties still surrounding the balance of political forces in Italy, pressure against the lira may be expected to continue despite the prospect of another large current account surplus this year.

The Netherlands

21. The Dutch economy, virtually stagnant during 1971 and much of 1972, has begun to show some signs of recovery. Revived consumer spending and rising foreign orders have spurred industrial production. Investment, down sharply earlier in the year, also has increased markedly in recent months as businessmen assess their domestic and foreign sales prospects more optimistically. Real economic growth for the year was

approximately 3.5%. Inflation and unemployment remain major problems. In the absence of a firm government anti-inflationary policy – itself a reflection of political instability – price increases accelerated during the year and the cost of living rose about 7.5%, one of the highest rates in Western Europe. Unemployment also rose, averaging 3% of the labor force, a very high rate by Dutch standards and nearly double the rate in 1971.

22. Recovery is expected to accelerate during the coming months. The government forecasts 4-1/2% real growth for GNP. Industrial production should rise significantly, aided by greater economic momentum in West Germany and other principal trading partners as well as by increased domestic business investment. The unemployment problem may ease slightly in the course of the year, but unless wage increases are brought under control – unlikely regardless of what new government coalition will be formed – inflationary pressures will intensify.

Norway

23. Led by a revival of export demand, Norway's economy overcame a weak start to grow by 4.2% in real terms during 1972. A cyclical upturn in foreign demand for pulp, paper, and metals combined with a moderate increase in consumer expenditures to reverse the slowdown which had reduced the growth of industrial production to 2% in the early months of 1972. Reflecting a tightening profit squeeze and uncertainties regarding Norwegian membership in the EC, industrial investment was down nearly 4% from 1971. Unemployment remained low. Spurred on by wage increases exceeding 12% annually during 1970-71, inflation remains a major problem, with consumer prices rising 7%. This inflation, felt mainly in the area of retail prices, contributed to the early weakness of consumer demand.

24. The recent upswing is expected to continue, led by a revival of investment expenditures, strengthening consumer demand, and buoyant exports. Real economic growth for the year is expected to reach 4%-5%. The moderation in wage settlements for 1973-74 should help reduce the increase in living costs to a more reasonable 5%.

Sweden

25. The cyclical downturn in the Swedish economy bottomed out in mid-1972. Government pump-priming expenditures, incentives for industrial investment, and rising export demand for lumber, paper, and steel turned the stagnation of the first six months into a modest recovery. Real growth of GNP exceeded 2%, compared with virtually zero growth in 1971. Despite the recovery, industrial production failed to grow, as producers dipped into inventories to supply their demands. Consequently

unemployment – about 3% of the labor force – continued to be an embarassing problem for the socialist government committed to a full employment policy. Reflecting this high rate of unemployment (by Swedish standards) and the related increase in savings out of income, consumer demand remained weak. The rise in living costs eased somewhat to 6.4% in 1972, compared with a 7.3% rise in 1971. Export prices, however, remained unchanged, leaving Sweden in an improved international competitive position.

26. Prospects for 1973 are for real GNP to grow about 4%. Increases in government spending, rising industrial investment, and some inventory building, along with strong export demand, are the leading forces in this continued modest recovery. The employment picture is not expected to improve significantly, because productivity gains are likely to match a modest rise in industrial production.

Switzerland

27. The mild two-year cyclical downturn in Switzerland has bottomed out. Since mid-1972 the economy is showing increasing signs of renewed vitality. Private consumption, government expenditures, and residential construction were the main props of the economy earlier in the year. More recently, industrial investment and exports have also picked up. For the year as a whole, real economic growth was 4.5%, up from 4% in 1971. The labor market has remained extremely tight, and rising wages, together with rising costs of imports, have fueled the most severe inflation in Swiss postwar history. Consumer prices rose 7% in 1972 and are forecast to climb by as much as 10% in 1973. In the face of these predictions, the government intensified its anti-inflation program, further tightening credit, restricting foreign investment tax write-offs, and establishing an unprecedented wage/price surveillance mechanism.

28. Real economic growth is expected to exceed 4% in 1973, supported primarily by a further increase in private spending on housing construction and services. Substantial increases in public expenditures, especially by cantonal and local governments beyond the control of the federal authorities, also will have an expansionary impact on the economy, as will a further rise in export demand. In view of the persisting manpower shortage and full utilization of productive capacity, inflationary pressures will intensify, possibly forcing the government to introduce wage and price controls as a measure of last resort.

United Kingdom

29. Despite strikes that cost Britain more working days than in any year since 1926, real GNP expanded by about 3.5% – markedly faster than

in the previous three years, when growth averaged less than 2% annually. Private consumption, stimulated by governmental measures including an expansionary budget, led the revival. Fixed investment, however, remained sluggish during most of the year.

30. Despite faster economic growth, serious problems remain. Unemployment averaged 3.8% in the first three quarters of 1972, compared with 3.2% (a rate considered high in Britain) for the comparable 1971 period. Pump-priming the economy produced a record budget deficit and contributed to rampant inflation. In 1972, retail prices climbed 8% and accelerated prior to the November freeze on wages and prices, which followed collapse of tri-partite (government, business, and labor) attempts to reach voluntary restraints. Moreover, despite the June sterling float, which has devalued the pound by about 10% relative to its Smithsonian central rate, Britain's old nemesis, the balance-of-payments deficit, is back. Speculative capital outflows pushed the official settlements balance into the red in the second quarter of 1972. In the third quarter, the current account went into deficit as the trade balance deteriorated. The third quarter trade results were, of course, distorted by the dock strike; nevertheless, an underlying unfavorable trade balance is suggested by the deficits posted subsequently.

31. Continued pump-priming and a possible light investment upturn should boost growth to 4-1/2% in 1973. Unemployment may decline somewhat, but inflation and the balance of payments are likely to remain serious problems. The Heath government is following up its initial 90-day wage and price freeze with a "Phase II" to last a year. Price hikes resulting from implementation of the value-added tax and partial accommodation to the EC's common agricultural policy this year will increase the need for tough restraints. While action on the wage and price front may ease inflation somewhat, the foreign trade balance will probably deteriorate further. Exports, benefiting from the lagged effects of the sterling float and from less rapid rise in production costs, should expand – but not as fast as imports. Capital inflows, however, probably will offset some of the current account deficit as international monetary relationships return to a more normal condition.

West Germany

32. The West German economy fared better in 1972 than had been generally expected. Widespread fears of a drastic decline in business activity during the first half of the year proved groundless. A high level of construction and buoyant consumer spending, as well as the return to fixed parities following the Smithsonian agreement, helped dispel the gloom in the business community. With investment and export demand also gradually

rising in recent months, real economic growth for the year reached more than 3%. Unemployment remained low, averaging about 1% for the year. Inflation is the principal problem facing Bonn's policy makers. Despite restrictive monetary and fiscal measures, the cost of living rose steadily throughout the year. The consumer price index in December was up 6.5% from a year ago.

33. Government and business leaders generally predict a substantial upturn in the rate of economic growth in 1973 – to about 6% in real terms. Industry has upped its investment plans, and business surveys show that consumers, anticipating further sizable wage increases, plan to increase their purchases of cars and large household appliances. Finally, more rapid growth in the United States and other major West German trading partners promises a rising foreign demand for German products. With private sector spending accelerating, inflationary pressures are likely to intensify unless the rise in government spending is curbed or taxes are raised. Brandt now enjoys a comfortable majority in parliament, but it remains to be seen whether he will be able to enforce budgetary discipline on federal finances and enlist the cooperation of state and local governments as well. While the government may impose selected tax increases in the course of the year, the Bundesbank undoubtedly will continue to carry the brunt of the anti-inflation fight. Its ability to tighten domestic monetary policy is limited, however, by developments in the principal foreign money markets. Rising interest rates in the United States in the course of 1973, as now appear likely, should increase the effectiveness of the Bundesbank's anti-inflationary policies.